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IN THE

Supreme Court of the United States

OCTOBER TERM, 1925.

No. 337.

THE UNITED STATES,

Appellant,

vs.

P. CHAUNCEY ANDERSON, *et al.*,

Appellees.

APPEAL FROM THE UNITED STATES COURT OF CLAIMS.

BRIEF FOR APPELLEES.

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INDEX.

	PAGE
Table of Cases.....	III
Statutes	III
History of the Case	1
Statement of Facts	2
Question Presented	3
Summary of Argument	4

ARGUMENT:

I. Under the Revenue Act of 1916, taxes may properly be taken as a deduction from income only in the year when paid, regardless of the character of the tax return made.....	5
The manner of keeping appellees' books	5
The method of making appellees' returns	6
(a) The administrative practice which had grown up under the prior Income Tax Acts clearly required that taxes be taken as a deduction only in the year when paid	7
The prior Income Tax Acts.....	7
The 1916 Act and the Regulations issued thereunder	9
(b) Under the 1916 Act, only taxes actually paid within the year were deductible in determining taxable net income, whether the tax returns were made on the so-called cash basis under Sections 10 and 12(a), or under the alternative basis contemplated in Section 13(d).....	11
"Paid" does not mean "paid or accrued"	12

II

	PAGE
The Government's position as to Section 13(d)	13
The true function of Section 13(d) ..	15
The Regulations issued under Section 13(d) preclude the deduction of the 1916 munitions tax in 1916.....	16
II. The appellees' munitions tax for 1916 did not accrue until 1917, in which year it was assessed, became due and payable, and was in fact paid, and consequently it was properly deducted from income of that year.....	
The Government's interpretation of the phrase "taxes accrued"	18
The Government's suggested rule as to the time when a tax accrues....	21
The attempted distinction of the Woodward case	21
No analogy between taxes and expenses	24
The accounting authorities do not support the Government	24
III. The Burton-Richards Company made its returns for 1916 and 1917, not under the alternative provisions of Section 13(d), but under the provisions of Sections 10 and 12(a). That being the case, there can be no dispute that its 1916 munitions tax was deductible in 1917, the year when it was paid.....	
Absence of evidence of election to use Section 13(d).....	26
Alleged inconsistency in appellees' position	28
Alleged inconsistency in appellees' position	31
Conclusion	32
Appendix A	33
Appendix B	35

III

TABLE OF CASES.

	PAGE
Brilliant Coal Co. v. U. S., 59 Ct. Cl. 481.....	12
Clapp v. Mason, 94 U. S. 589.....	18
Doyle v. Mitchell Bros. Co., 38 Sup. Ct. 467; 247 U. S. 179	15
Edwards v. Slocum, 44 Sup. Ct. 293; 264 U. S. 61....	22
Lane County v. Oregon, 7 Wallace 71.....	17
Mason v. Sargent, 104 U. S. 689.....	18
Meriwether v. Garrett, 102 U. S. 472, 513.....	17, 24
National Lead Co. v. U. S., 40 Sup. Ct. 237; 252 U. S. 140.....	12
Schuster v. Williams (C. C. A., 7th Circuit), 283 Fed. 115, 116	25
Shwab v. Doyle, 42 Sup. Ct. 391; 258 U. S. 529.....	12
Sturges v. U. S., 6 Sup. Ct. Rep. 767; 117 U. S. 363..	18
United States v. Woodward, 41 Sup. Ct. 615; 256 U. S. 632.....	18, 21, 24

STATUTES.

Act of August 5, 1909 (Chap. 7), 36 Stat. L. 112, known as Corporation Excise Tax Act...7, 11, 27, 29, 33	
Act of October 3, 1913, 38 Stat. L. 114, 166, known as The Revenue Act of 1913.....8, 11, 27, 29, 33	
Act of September 8, 1916, 39 Stat. L. 756, known as The Revenue Act of 1916.....2, 5, 9, 11, 26, 30, 33	
Act of October 3, 1917, 40 Stat. L. 300, amending Rev- enue Act of 1916.....	14
Act of February 24, 1919, 40 Stat. L. 1057, known as The Revenue Act of 1918.....	12



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P. CHAUNCEY ANDERSON, *et al.*,
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BRIEF FOR APPELLEES.

History of the Case.

This is an appeal taken by the United States from a decision of the United States Court of Claims awarding judgment to the appellees, the claimants below, in the sum of \$19,749.55, as a refund for taxes erroneously assessed and collected by the Commissioner of Internal Revenue under the Revenue Act of 1916, as amended.

The petition was filed in the Court of Claims on February 28, 1923, followed by an amended petition filed on April 26, 1923. In the absence of demurrer, plea or answer to the petition, a statutory general traverse was duly entered under Rule 34 of the Court of Claims. The case was heard on an agreed statement of facts on December 9, 1924, and judgment for the complainants, in the sum noted above, was entered on January 5, 1925. The opinion of the Court of Claims is reported in 60 Ct. Cl. R., and appears on page 17 of the record herein.

Statement of Facts.

The appellees herein are the Trustees in dissolution of the Burton-Richards Company, a corporation in dissolution under the laws of the State of Delaware. The sum of \$19,749.55, for which judgment in the court below was given, represented additional income taxes assessed and collected for the year 1917 under the provisions of the Revenue Act of 1916, as amended. These additional taxes were paid to the Collector of Internal Revenue at Cleveland, Ohio, under specific written protest, and upon the denial of a claim for refund duly filed with the Commissioner of Internal Revenue at Washington, the complainants immediately filed their suit.

The Burton-Richards Company during the year 1916 was engaged in the manufacture and sale of explosives, and in that year showed a taxable profit of \$899,356.32 from such manufacture and sale. Under Title III of the Revenue Act of 1916 (39 Stat. L. 780), a so-called "Munition Manufacturer's Tax" of 12½% was imposed upon such net profits, making a total munitions tax for 1916 of \$112,419.54. This munitions tax, while measured by the net profit shown in 1916, did not become due and payable until thirty days after assessment by the Commissioner of Internal Revenue and such assessment could not be made until after March 1, 1917, the date when the munitions tax return was due and filed.

The munitions tax return of the Burton-Richards Company for 1916, filed on March 1, 1917, showed a munitions tax due of \$86,541.95. This amount was duly assessed by the Commissioner and paid on May 14, 1917. Thereafter, upon audit by the Commissioner, additional assessments were made aggregating \$25,877.59, of which \$21,510.09 was paid on September 6, 1917, and \$4,367.50 on October 31, 1917. These additional assessments resulted from a reduction by half in depreciation taken in respect of buildings and machinery, and the addition to income of sundry items.

In addition to its munitions tax for 1916, the Burton-Richards Company early in 1917 filed its income tax return

for 1916 and paid income tax upon the net income as returned therein. In making out this income tax return for 1916, the 1916 munitions tax was not claimed as a deduction. In the year following, however, the corporation in accordance with the existing regulations of the Treasury took as a deduction in its 1917 return the total amount of \$112,419.54 paid in 1917 as a munitions tax on account of its 1916 munitions profits.

In auditing the Burton-Richards income tax returns for the years 1916 and 1917, the Bureau of Internal Revenue at first acquiesced in the course adopted and permitted the taxpayer to deduct its 1916 munitions taxes in reaching net income subject to tax for the year 1917. Thereafter, to wit, on the 28th day of April, 1920, the corporation formally filed its certificate of dissolution with the proper authorities, and proceeded at once to distribute its assets to its stockholders.

Some two years after the dissolution of the company, the trustees in dissolution were surprised to receive a letter dated September 23, 1922, from the Revenue Agent in Charge at Cleveland advising the company that its 1916 munitions tax of \$112,419.54, although paid in 1917, had been erroneously deducted in its 1917 return from its 1917 income and must be restored. Thereafter the Commissioner of Internal Revenue confirmed the Revenue Agent's position and on November 23, 1922, made an additional assessment against the Burton-Richards Company of \$19,749.55. The amount was paid under protest (R. 9), a claim for refund was made and denied (R. 10, 11, 12) and this action followed.

The Question Presented.

The Statutes and Regulations involved are printed in the Appendix. The sole question presented is whether a corporate taxpayer may take as a deduction in its income tax return for the year 1917 a munitions tax measured by its net profits in 1916 but assessed, due and actually paid in 1917.

SUMMARY OF ARGUMENT.

I.

Under the Revenue Act of 1916, taxes may properly be taken as a deduction from income only in the year when paid, regardless of the character of the tax return made.

(a) *The administrative practice which had grown up under the prior Income Tax Acts clearly required that taxes be taken as a deduction only in the year when paid.*

(b) *Under the 1916 Act, only taxes actually paid within the year were deductible in determining taxable net income, whether the tax returns were made on the so-called cash basis under Sections 10 and 12(a), or under the alternative basis contemplated in Section 13(d).*

II.

The appellees' munitions tax for 1916 did not accrue until 1917, in which year it was assessed, became due and payable and was in fact paid, and consequently it was properly deducted from income of that year.

(a) *This court in U. S. v. Woodward, 256 U. S. 632, has definitely ruled that taxes accrue when they become due.*

(b) *The decision in the Woodward case governs the instant case.*

III.

The Burton-Richards Company made its returns for 1916 and 1917, not under the alternative provisions of Section 13(d), but under the provisions of Sections 10 and 12(a). That being the case, there can be no dispute that its 1916 munitions tax was deductible in 1917, the year when it was paid.

IV.

Conclusion.

ARGUMENT.

I.

Under the Revenue Act of 1916, taxes may properly be taken as a deduction from income only in the year when paid, regardless of the character of the return made.

The appellant in attempting to justify the position of the Commissioner of Internal Revenue in refusing to allow the Burton-Richards Company to take as a deduction from gross income in 1917 its 1916 munitions tax which was paid in 1917, relies upon the manner in which the Burton-Richards Company kept its accounts for the year 1916 and the basis upon which its income tax return for 1916 was made. It contends that in view of the manner of keeping accounts and making return the provisions of Section 13(d) of the 1916 Act not only permitted but required the Burton-Richards Company to take its 1916 munitions tax as a deduction in 1916 or not at all.

The Manner of Keeping the Books.

In keeping its books for the year 1916, the Burton-Richards Company took up on its books all items of gross income and general business expenses as and when such items became fixed and ascertainable in the form of accounts receivable and accounts payable regardless of whether the amounts shown were actually received or paid in cash. Interest was entered on its books during 1916 only as and when actually received or paid within the year. The Company's interest on its indebtedness was all paid in 1916, and so appeared on its books. No losses nor bad debts appeared in 1916, nor were any set up on its books during that year. The Company set up on its books month by month an arbitrary "reserve for taxes" of \$35,000, as set forth in paragraph

5 of the Findings of Fact (R. 13). It did not pretend in so doing to be "accruing" the amount for income tax or other purposes. The service of such an entry was solely to reflect in conjunction with other entries the general financial condition of the Company as a going concern and to guide it in the declaration of dividends or the making of other disbursements.

The Method of Making Returns.

The original and amended income tax returns of the Burton-Richards Company for 1916 and 1917 were made a part of the stipulation of facts in the court below. In these returns there was included as gross income all items arising from sales made within the year whether paid or payable in cash, while the company took as deductions:

- (a) General expense, whether paid in 1916 or not;
- (b) Depreciation charged off;
- (c) Interest paid; and
- (d) Taxes, domestic, paid.

As a result of this method of keeping its accounts and making its return for 1916, the appellant maintains that the return must be taken to have been made on what it terms "the accrual basis", as distinguished from a return made on "the cash basis", and as the Company's 1916 munitions tax "was accrued" in 1916, it must be taken as a deduction in 1916.

Historical Survey.

Throughout the Government's brief much is said of "the cash basis" and "the accrual basis" of making income tax returns, the inference being that these two methods of making return are exclusive and mutually independent. The fact is that these two terms are not self-explanatory, but require

clarification. Before proceeding with the argument it may be of some service to outline briefly the structure of the earlier Income Tax Acts and the administrative procedure which grew up under them, in order that the Court may have before it the situation as it existed on the enactment of the 1916 Revenue Act.

(a) The administrative practice which had grown up under the prior income tax acts clearly required that taxes be taken as a deduction only in the year when paid.

In the earlier Income Tax Acts Congress did not make what is commonly known as "commercial net income" the basis for the tax levy. That which is subject to tax under these several Acts is "net income", and in every case "net income" is ascertained by deducting from gross income certain arbitrary deductions. In the first of the so-called Income Tax Acts, namely, the Excise Tax Act of 1909, the net income subject to tax was determined by deducting from the gross amount of income "received within the year":

- (1) The ordinary and necessary expenses "actually paid within the year",
- (2) "losses actually sustained within the year",
- (3) "Interest actually paid within the year", and
- (4) "Sums paid by it within the year for taxes".

Thus the gross income which was taken as the starting point was the gross income "received", and the several deductions allowed were ordinary and necessary expenses "actually paid", losses "actually sustained", interest "actually paid", and taxes "paid."

Obviously, a literal interpretation of the 1909 Act demanded a strict and thorough going cash basis for making return and paying tax. Yet, from the first, the Treasury Department, in its formal regulations issued under the 1909 Act, not only permitted but required a departure from a strict cash basis. In Article 5, Regulations 31, issued under the 1909 Act, inventories were not only permitted

to be taken but they were said to be "essential" in the proper preparation of a corporate return; while in Article 4 of the same Regulations, in speaking of deductions it was stated "it is immaterial whether the deductions are evidenced by actual disbursements in cash or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so interpreted on the books *as to constitute a liability against the assets of the corporation.*" (Italics ours.) But T. D. 1742, which constituted paragraph 77 of Regulations 31, specifically provided that reserves for taxes could not be allowed, as in the words of the Regulation, "the law specifically provides that only such sums as *are paid* within the year for taxes can be deducted". (The words "are paid" are italicized in the official text.)

With these formal regulations issued by the Treasury Department before it, Congress, in passing the 1913 Revenue Act, employed substantially the same phraseology as to gross income, business expenses, losses, interest and taxes as it had employed in the 1909 Act. Following the passage of this Act the Treasury Department in its formal regulations (Regulations 33, issued Jan. 5, 1914) defined gross income in Article 104 thereof as "the total sales of manufactured goods during the year," required the use of inventories and specifically provided in Article 158 regarding deductions that "it is immaterial whether the deductions, except for taxes and losses, are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation making the return." But, in the same Article, the deduction for taxes was limited to amounts "actually paid" within the year, and Article 156 specifically provided that "reserves for taxes cannot be allowed".

There is attached hereto as Appendix "A" a comparative statement setting forth the relative provisions of the 1909, 1913 and 1916 Acts regarding the respective methods prescribed for arriving at taxable net income, and as Appendix "B" the pertinent parts of the respective Treasury Regulations issued under those Acts.

This interpretation of the phrases "gross income received" and "ordinary expenses paid" was essential to any reasonable interpretation of the two Acts. The enforcement of a literal cash receipts and disbursements basis, so far as gross income and business expenses are concerned, would have been impossible in the case of corporations engaged in manufacture, and if insisted upon would have resulted in returns and taxes thoroughly at variance with the true state of affairs. But while departure from the strict cash basis was both permitted and required in fixing gross income and business expenses, when it came to taxes, the Treasury, as noted above, invariably permitted them to be taken as deductions only in the year when "actually paid".

Thus, the basis employed in making returns under the 1909 and 1913 Acts, though commonly referred to as the *cash or receipts and disbursements* basis, was in point of fact a basis which took into income accounts receivable as well as received in cash, and permitted as deductions for the ordinary and necessary business expenses amounts payable although not actually paid in cash. But taxes were permitted as a deduction only in the year in which the taxes were in fact paid.

The 1916 Act and Regulations Issued Thereunder.

Having before it the Treasury regulations issued under the 1909 and 1913 Acts, Congress framed and enacted the Revenue Act of 1916. Reference to the comparative statement in Appendix "A" attached hereto shows that the 1916 Act employed the same phraseology as the earlier Acts had used in defining net income subject to tax, that is, gross income, the starting point, was income "received within the year", and in reaching taxable income the deductions allowed were: first, the ordinary and necessary expenses "paid within the year"; second, "losses actually sustained"; third, "interest paid within the year"; fourth, "taxes paid within the year".

The Treasury Department in its regulations under the 1916 Act, namely Regulations 33 (Revised), as in the prior regulations under the 1909 and 1913 Acts, defined gross income as "the total sales * * * during the year" (Article 91), required that inventories "must be taken where the business consists of buying and selling commercial commodities" (Article 120), and in Article 126, in defining the word "paid" it was flatly stated: "If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly deductible even though not actually disbursed in cash, provided it is so entered on the books of the company as to constitute a liability against its assets". But again, so far as taxes were concerned, Regulations 33 (Revised), in Article 191 thereof, permitted as a deduction for taxes only such taxes as were "paid within the year".

It is evident from the foregoing that the so-called cash or receipts and disbursements basis used under the 1909 and 1913 Acts and recognized at least for a time under the 1916 Act, was not and never had been a literal cash basis. It was in reality a mongrel basis which had taken shape on account of the very necessities of the case and which after adoption had received Congressional sanction by the subsequent re-enactment of similar provisions of law. More properly it should be termed the *statutory* cash basis rather than *the* cash basis, a term which obviously is a misnomer. This statutory cash basis was consistently recognized and employed by the Treasury Department in administering the several income tax acts until the issuance in January, 1921, of the opinion of the Solicitor of Internal Revenue known as L. O. 1059 (see Cumulative Bulletin 4, p. 147), the opinion upon which the Commissioner acted in disallowing the deduction for taxes and which gave rise to the instant case, an opinion which constituted an entire reversal of the Treasury's prior practice in treating the deduction for taxes.

(b) Under the 1916 Act only taxes actually paid within the year were deductible in determining taxable net income, whether the tax returns were made on the so-called cash basis under Sections 10 and 12(a), or under the alternative basis contemplated in Section 13(d).

With the previous history in mind, we come to a consideration of the 1916 Act. It is the contention of the appellees, as we point out hereafter, that the Burton-Richards Company's 1916 and 1917 returns were made on the statutory cash basis under Sections 10 and 12(a), thus removing any possible doubt as to the right to deduct taxes paid within the year. Passing over this point for the moment, it is submitted that whether the basis used was the cash basis or the basis contemplated by Section 13 (d), only taxes actually paid within the year could be taken as deductions in determining the taxable income for that year.

By the express provisions of the 1916 Act, that which is subject to tax is "net income", and "net income" must be determined by deducting from "the gross amount of its income received within the year" certain arbitrary deductions. One of these deductions, among others, is "taxes paid within the year imposed by the authority of the United States or its territories". This is a clear, unequivocal provision of law, a provision so clear and unequivocal that neither the tax payer nor the Commissioner in administering the Act can depart from its plain import without very clear ground for interpreting the word otherwise.

On the contrary, all indications are that Congress intended to limit the deduction for taxes in any particular year to an amount not exceeding that actually paid within the year. The Excise Tax Law of 1909 and the Income Tax Act of 1913, as well as the Regulations issued thereunder, were perfectly clear in this regard, and as stated above it was the uniform practice of the Commissioner of Internal Revenue under those Acts not only to permit but to require the deduction of taxes only for the year in which such taxes were in fact paid. Thus, at least until the passage of the

1916 Act, the law, the regulations and the administrative practice in the Bureau were uniform in this regard.

When enacting the 1916 Act, Congress again employed the word "paid", and "paid" alone, in describing the allowable deductions for taxes. The re-enactment by Congress of provisions similar to those employed in an earlier Act which had received a certain construction by the Executive Department charged with the administration of the Act "amounts to an implied recognition and approval of the executive construction of a statute." *National Lead Co. v. U. S.*, 252 U. S. 140. Whatever may be the effect of the appearance of Section 13(d) in the 1916 Act, there is no warrant in law for imputing to Congress an intent to permit or require the deduction of taxes in any taxable period other than that in which such taxes were actually paid.

"Paid" Does Not Mean "Paid or Accrued".

That Congress was familiar with the word "accrued" is evidenced by the phraseology used in the Munitions Tax law, which was Title III of the Revenue Act of 1916. In Section 302 of that title it was provided that in computing the net profit there shall be allowed as deductions "from the gross amount received *or accrued* for the taxable year * * * the following items". (Italics ours.) Had Congress intended the word "paid" in Section 12(a) of the 1916 Act to mean "paid or accrued", it would have said so. In the relative provision of the 1918 Act, namely, Section 234(a) (3), Congress did say so, for that Act permitted the deduction of taxes "paid or accrued within the taxable year". To permit or acquire under the 1916 Act the deduction of taxes when accrued rather than when paid would be to impute to Congress an intent in enacting the 1916 Act to which it first gave expression in the 1918 Act. This is not to be done. *Shwab v. Doyle*, 258 U. S. 529, 536.

In the case of *Brilliant Coal Co. v. U. S.*, 59 Ct. Cl., 481, it appears that the Commissioner of Internal Revenue attempted to do in regard to interest exactly what here has been

attempted in regard to taxes. In a well considered opinion, the Court of Claims ruled that the 1916 Act in using the phrase "interest paid" meant interest paid and not interest accrued, and allowed the Brilliant Coal Co. to recover the additional tax which it had been compelled to pay on account of the Commissioner's unwarranted interpretation. Appeal was taken from the Court of Claims' decision, but when the appeal came on to be heard it was dismissed on the motion of the Solicitor General. Certainly, if the position taken by the Commissioner is not maintainable in regard to interest, it is even more infirm in regard to taxes. The argument (which is set forth in L. O. 1059 attached to appellant's brief in this Case) that Section 13(d) qualifies the manner of making deductions authorized in Section 12(a) of the Act so that the word "paid" in Section 12(a) is to be read "paid or accrued" is without foundation.

The Government's Position.

It is not clear from the Government's brief whether its present position is that taken by the Solicitor of Internal Revenue in L. O. 1059, or whether it has now abandoned that position and undertakes to justify the requirement that taxes be taken in a year other than the year when paid on the ground that Section 13(d) in and of itself sets up a separate method of arriving at net taxable income quite distinct from that prescribed in Sections 10 and 12(a) of the Act; for in its brief, on page 29, it describes Section 13(d) as providing "an alternative method permitting a taxpayer if he kept his books on an accrual basis to make his return on that basis", and further contends that "if the taxpayer used the accrual basis in keeping his account and made his return on that basis, he cannot be permitted to depart from the accrual basis in dealing with any item of expense".

The proposition that Section 13(d) sets up a separate and distinct method of reaching taxable income is a strain upon its language, quite aside from the fact that its very position in the Act as a minor section can hardly justify giving it such dignity. The argument seems to be that Section 13(d),

in setting up the basis upon which the accounts are kept, contemplates a thorough-going return on the accounts basis, and that if the return is made on the accounts basis, every deductible item, including interest and taxes as well as business expenses, must be taken on the basis of the accounts. But obviously Congress did not contemplate that a taxpayer, regardless of the limitations imposed in Section 12(a) upon the extent of the deductions for interest and taxes authorized, might, nevertheless, take as a deduction an amount of interest or taxes merely by the simple device of setting up on its books a reserve for interest or taxes. Such a construction would put it in the power of the taxpayer to take as a deduction from net income an amount of taxes or interest which Congress said specifically in Section 12(a) could not be so taken.

For example, in 1917 Congress, by amendment to Section 12(a) of the 1916 Act, withdrew its grant of right to deduct Federal income and excess profits taxes. Suppose a taxpayer in 1917, keeping his accounts on what the appellant chooses to call the accrual basis, set up a reserve on its books for income and profits taxes and expressly made return under Section 13(d), claiming such reserve as a deduction. If the limitations contained in Section 12(a) do not limit the extent of the deductions which may be taken under the basis authorized in Section 13(d), then in 1917 the Commissioner, under appropriate regulations, might have authorized the deduction of income and excess profits taxes, even though Congress had expressly prohibited such a deduction. To assign to a subordinate section of a Revenue Act an interpretation susceptible of such a far reaching result is obviously unsound.

It is arguable that Section 13(d) to a limited extent contemplated the so-called "accrual" system of accounting and that Congress by inserting that section in the 1916 Act intended to give express recognition and legislative sanction to the practice which had grown up under the earlier Acts by administrative regulation of permitting and even re-

quiring the use of accounts receivable in determining gross income, and accounts payable in reaching deductible business expenses. In fact, it may be that the insertion of Section 13(d) in the 1916 Act foreshadowed the decision of this Court in *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, in the sense that it was an express recognition by Congress of the necessity of subtracting from gross income the cost of earning gross income in reaching that "income" which alone is taxable under the Constitution. But it is hardly conceivable that Section 13(d) authorized deductions for such items as taxes and interest without regard to the specific limitations placed on such deductions in Section 12(a). It is true that the right to employ Section 13(d) is made subject to regulations issued by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, but an interpretation of Section 13(d) which would permit, under appropriate regulation, deductions for interest and taxes other than those specified in Section 12(a) would vest in the Executive branch of the Government a discretion clearly not intended, and one which would perhaps amount to an unconstitutional delegation of authority.

The True Function of Section 13(d).

The fact is that Section 13(d) was not a recognition of the so-called accrual system of accounting as the Treasury would have us believe, but contemplated a great variety of methods of accounting. The words "accrue" or "accrual" are nowhere used in the law. It is respectfully submitted that Section 13(d) represented the first step by Congress, though a cautious one, toward a recognition of the principle that there are a number of corporations, which, on account of the nature of the business in which they are engaged, employ a variety of accounting methods not adapted to making returns upon the so-called statutory cash basis, and that in such cases a return on the basis upon which the accounts are kept will more clearly reflect income than a return on the

statutory cash basis. For instance, take a corporation engaged on a large scale in coal mining or in ship building. In the case of the mining corporation good accounting would permit the writing off yearly on the books as current expenses of a large and varied number of items such as mine cars, underground trackage extensions, hoistways, and rock tunnels drilled to reach new coal. Or, such current items might with equal propriety be carried on the books to capital and depreciated yearly. In such a case, Section 13(d) would permit the taxpayer to make his return and pay income tax in accordance with the way his accounts are kept, provided that such return with a fair degree of accuracy reflects his income.

Again, consider a ship-building company where the product made requires two or more years to complete. Such a corporation may either enter on its books annually as income a proportional amount of the anticipated profits from the sale of the article or it may take up the entire profit as income in the year when realized. Similarly, it may with propriety treat expenses in building a ship as applicable to different tax periods in accordance with the method of accounting which it employs. Here again Section 13(d) would permit the taxpayer to make his return upon the basis on which its accounts were kept and take up as income on its return items of income as shown on its books, provided that the return so made reflected its income with a real degree of accuracy.

In none of these special cases, however, may such items as losses, interest and taxes be taken as deductions except as permitted in Section 12(a).

The Regulations Issued Under Section 13(d) Preclude the Deduction of the 1916 Munitions Tax in 1916.

The right to make a return under Section 13(d), moreover, was by the very terms of that Section "subject to regulations made by the Commissioner". The contemporaneous

regulation made by the Commissioner covering 13(d) was T. D. 2433. This provided for the deductions of certain reserves from income, if those reserves were set up on the books of the taxpayer.

In the last paragraph of this regulation its application is limited by the following provision:

"The reserves contemplated by the foregoing rule are those reserves only which are set up to meet some *actual liability incurred*, the amount necessary to discharge which cannot at the time be definitely determined." (Italics ours).

This language leaves the reserve for taxes established by this taxpayer outside the bounds of the Treasury Decision, since the munitions tax here involved was not an actual liability at December 31st, 1916. Taxes constitute a liability only when they become due or at the earliest when they are assessed.

Lane County v. Oregon, 7 Wallace, 71;
Meriwether v. Garrett, 102 U. S. 472, 513.

That T. D. 2433 was not intended to permit taxpayers to deduct reserves for taxes is indicated not only by the contemporaneous action of the Commissioner, but also by the specific provisions of T. D. 2490, issued January 2, 1918, nearly a year after T. D. 2433, under which Treasury Decision taxes deductible were without qualification described as "taxes paid within the year".

II.

The appellees' munitions tax for 1916 did not accrue until 1917, in which year it was first assessed, became due and payable, and was in fact paid, and consequently it was properly deducted from income for that year.

The tax in the instant case was formally assessed and became due in the year 1917. It certainly could not accrue at any earlier date. *United States v. Woodward*, 256 U. S. 632, *Clapp v. Mason*, 94 U. S. 589; *Mason v. Sargent*, 104 U. S. 689; *Sturges v. United States*, 117 U. S. 363.

In the course of its opinion in the *Woodward* case, the court said:

"Here the estate tax not only 'accrued', which means became due, during the taxable year 1918, but it was paid before the income for that year was returned or required to be returned. When the return was made the executors claimed a deduction by reason of that tax. We hold that under the terms of the Act of 1918 the deduction should have been allowed."

True, the *Woodward* case was a case involving the estate tax, while the tax here in question is a so-called munitions tax. But surely the rule as to when a tax accrues must be uniform without regard to the nature of the tax, for uniformity in taxing statutes will be presumed unless there are clear reasons for a difference in treatment.

But the Government seeks to avoid the decision in the *Woodward* case, if not to obtain a reversal of the principle therein established.

The Government's Interpretation of the Phrase "Taxes Accrued."

In its discussion of the question, the appellant wavers between two interpretations of the phrase "taxes accrued", one interpretation being taxes which have accrued, the other,

taxes which have been, or perhaps rather should have been, accrued. The first phrase is one, in the interpretation of which aid can be derived from the general dictionaries, from legal dictionaries and legal decisions. The phrase "taxes which have been accrued" is not susceptible of such interpretation, since no transitive use of the word "accrue" is recognized in dictionaries, either legal or general, or in any court decisions with which we are familiar.

In this connection it is interesting to observe that throughout its discussion the appellant cites no legal authorities in support of its position. The interpretation of the phrase "taxes which have been accrued" has to be deduced mainly from the context in the appellant's brief. It apparently means taxes which have been or should have been taken up on the books of the company, the bookkeeper being in this case an active agent who "accrues" the tax, instead of the tax itself accruing in the due course of events as it does in the more customary concept.

As between these two alternative interpretations, the appellant seems at times to lean towards the meaning taxes which have accrued, possibly thinking that in doing so it can derive some support from the subsequent allowance of taxes accrued as a deduction under the 1918 Act. At other times, it seems to lean towards the interpretation taxes which have been accrued, apparently because this interpretation brings its contentions more nearly in accordance with the provisions of Section 13(d) of the 1916 Act, which provides for returns being made under certain circumstances on the basis on which the accounts of the taxpayer are kept. It must, however, stand or fall on one interpretation or the other. It cannot shift from one to the other as expediency may seem to make a shift desirable.

Valuable light is thrown on this point by the appellant's action in case No. 420, in which its main argument on this question is presented. The glaring inconsistencies resulting from the appellant's theory in that case will no doubt be presented in the appellee's brief. The facts therein are

here referred to only to interpret the appellant's use of the word "accrued."

From the findings in that case it appears that in 1916 the taxpayer actually paid and took as a deduction in its return taxes amounting to \$85,758.75, that it set up or "accrued" on its books in that year a reserve for taxes amounting to \$449,312.33, of which \$247,763.19 was for munitions tax. It further appears that the amount of taxes paid in 1917, which the Commissioner has now thrown back into 1916, was only \$255,696.73, being the precise amount of munitions tax paid in 1917. This amount added to taxes paid in 1916 makes a total of only \$341,455.48, or some \$108,000 less than the amount "accrued" on its books by the taxpayer at December 31, 1916. In part, this difference doubtless consisted of income taxes on 1916 income payable in 1917.

The following important facts immediately become apparent:

First, that the Commissioner has not adjusted the return for 1916 in respect of taxes to "the basis on which the accounts of the taxpayer were kept", seeing that the basis on which the books were kept called for the "accrual" of taxes amounting to \$449,312.33, while the Commissioner has allowed as a deduction not more than \$341,455.48.

Second, that the tax treated by the Commissioner as having "accrued" at December 31, 1916, is not measured by the reasonable estimate of such tax made by the taxpayer at December 31, 1916, of \$247,763.19 but by full amount of the tax subsequently ascertained to be payable, on \$255,696.73.

Third, that the Commissioner has not allowed the taxpayer as a deduction in 1916 the income tax on its income for 1916, though consistency would require that it should be so allowed equally with the munitions tax.

In other words, the Commissioner has immediately fallen into inconsistency in applying his own rule and is, moreover, attempting to tax appellee by first holding that it must make its return on the basis of accruals, using "accrued" in one sense and then in computing the taxpayer's allowable deduc-

tions, interpreting the word "accrue" in a totally different and inconsistent sense.

It is, therefore, fairly inferable that when forced to an election the appellant elects to take its stand on the interpretation of taxes accrued as meaning taxes that have in law accrued. This being so, a large part of the discussion and the references to accounting authorities on the question how and when taxes ought to be accrued in books kept on an accrual basis become irrelevant and we, therefore, do not propose to discuss them.

The Government's Suggested Rule as to the Time When a Tax Accrues.

The appellant's contention is that a tax has accrued when the last event happens by which the liability of the taxpayer is determined, even though the determination of the tax is not made until a subsequent date. Upon this theory it urges that the munitions tax involved should be considered as having accrued in the last moment of 1916.

Attempted Distinction of the Woodward Case.

It seeks to distinguish this case from the *Woodward* case on the ground that the tax to which that case applied was an estate tax which might in some cases depend on events happening after the date at which it became due, and by conceding that in such an event the tax accrues at the time when it becomes due. More accurately stated then, its position is that a tax accrues *either* when the last event which determines the amount of the tax happens *or* when it becomes due, whichever occurs first. Such a rule is obviously lacking in one of the prime requirements of a satisfactory rule for such purposes, that of uniformity.

If the appellant's rule were accepted it would follow that the income tax for 1916 accrued in that year just as much as did the munitions tax. This would mean that the

income tax would have to be deducted, in arriving at the sum on which that tax was to be computed, a procedure which it is highly improbable that Congress intended, and which the findings in Case 420 show the Commissioner has not in fact adopted in practice.

It is easy to see how still more complicated algebraic computations might be required by the application of the appellant's method. If, for instance, taxes were deductible in computing the munitions tax in the same way as in computing income tax, we should have the position that the munitions tax and the income tax would both be deductible in determining the amount on which each was to be computed, and we should thus have precisely that case of two mutually dependent indeterminates on which this Court commented in the case of *Edwards v. Slocum*, 264 U. S. 61, 62, where it was said:

"The Government offers an algebraic formula by which it would solve the problems raised by two mutually dependent indeterminates. It fairly might be answered, as said by the Circuit Court of Appeals, that 'algebraic formulæ are not lightly to be imputed to legislators', but it appears to us that the structure of the statute is sufficient to exclude the imputation. As further remarked below, the theory departs from the long established practice of the law not to regard the incidence of a tax in the levying of a tax * * *".

The very impracticability of the appellant's rule as applied to conditions which are peculiarly liable to arise under a dual system of Federal and State taxation is sufficient to refute its soundness. .

The appellant, however, utterly fails to establish its distinction. Its contention is as follows (p. 40 of appellant's brief):

"The difference between the munitions tax of 1916 and the Federal estate tax is obvious. Every event constituting a factor in the ascertainment of the amount of munitions tax had occurred at the close of business

December 31, 1916. No business operation after that date could affect the amount of the tax. The factors constituting the basis for computation of the tax were all determined and known."

A single illustration will show the inaccuracy of these contentions. One of the most important elements in the determination of the munitions tax was the deduction to be allowed for amortization which was to be determined by the Commissioner under the following general provisions of the Act: "A reasonable allowance according to the conditions peculiar to each concern for the amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants."

In the computation of such amortization, one of the most important elements was the duration of the war. Will the appellant suggest that the allowance for amortization was not affected by the entry of the United States into the war on April 6, 1917, or the fact that the war ended on November 11, 1918, rather than April 6, 1917, or any other date? Will the appellant suggest that the entry by a taxpayer into a contract for munitions on January 1, 1917, would not affect the reasonable allowance for amortization of equipment theretofore employed in the manufacture of similar munitions? Will the appellant suggest that the facts constituting the basis for the computation of the tax were all determined and known when on December 31, 1916, it was not even determined what were munitions and what were parts of munitions, within the meaning of the Act? Controversies on these questions continued for years and some remain still unsettled. The fact is that the uncertainty attending the computation of the munitions tax in 1916 which could only be resolved by future events, were at least as many and as great as in the case of the ordinary estate tax. Moreover, there was always the possibility that the law would be changed before the tax became due, a possibility which approached more nearly to probability, as the United States drew nearer to war in the early days of 1917. It is

true that while the general structure of income taxation was twice changed during the year 1917, this particular provision was not disturbed. It will be recalled, however, that the tax for the taxable year 1918 was changed between the close of the year and the date when the tax became due. Similarly, the law was changed in 1924 in relation to the taxation of 1923, and another similar change is foreshadowed for the year now current. In some cases munitions taxes have not even yet been determined by the Commissioner, although it is nearly eight years since the law ceased to have any effect. Yet, according to the appellant's theory and consistently with its action in Case 420, these taxes when finally determined will be deemed to have accrued in the years 1916 or 1917.

There is No Analogy Between Taxes and Expenses.

The appellant appears to regard the treatment of taxes accruing before they are assessed or become due as justified on the analogy of its treatment of business expenses as accruing before the date when they become payable. The unsoundness of such an analogy is readily apparent. Business expense cannot be said to accrue until a legal liability therefor has been created. There was no legal liability for the munitions taxes in question until they were assessed and became due. Until that time there was always the possibility that they might never become liabilities through the repeal or change in the taxing statute. On this general question, the language of the court in *Meriwether v. Garrett*, 102 U. S. 472, 513, is apposite, and taken with the decision in the *Woodward* case is, we think, conclusive of the issue.

The Accounting Authorities Do Not Support the Appellant.

The appellant cites accounting authorities for the proposition which it advances as to when taxes accrue, but these authorities do not support the position the appellant has taken. Montgomery in the passage cited by the appellant speaks of the tax as "accruing throughout

the year", which is an essentially different theory from the appellant's that the tax accrues at the last moment of the year. All the arguments based on accounting practice and commercial convenience which the appellant seeks to take advantage of are wholly inapplicable to its present contentions.

It may also be pointed out that the *Woodward* decision rests on a sound economic basis in that whatever may be the basis or the *measure* of taxes, taxes are essentially contributions to the cost of government and as the law contemplates that the taxes will be paid when due, they are properly to be regarded as contributions to the expenses of the government in the period in which they become due, and therefore as charges or expenses applicable to that period. As the Court said in *Schuster v. Williams* (C. C. A., 7th Circuit, 1922), 283 Fed. 115, 116:

"There is no necessary relation between the basis for the levy and the time of accrual of the tax."

The rule that taxes accrue when they become due and payable, the rule announced by the court in the *Woodward* case, is a rule simple of understanding, economically sound, concise in terms and readily capable of uniform application without regard to the nature of the particular tax in question. One may well be loath to put an interpretation upon the word "accrue" which will require a departure from this simple rule and the sacrifice of its advantages to serve no purpose except to effectuate the Commissioner's belated reversal of opinion regarding a provision which was only of transitory importance and which ceased to be effective nearly eight years ago.

III.

The Burton-Richards Company made its returns for 1916 and 1917, not under the alternative provisions of Section 13(d), but under the provisions of Sections 10 and 12(a). That being the case, there can be no dispute that its 1916 munitions tax was deductible in 1917, the year when it was paid.

(a) The returns were made on the statutory cash basis under Sections 10 and 12(a).

The Government concedes (Brief, pp. 4 and 5) that if the Burton-Richards Company made its return on a "cash basis", its munitions tax for 1916 was deductible in the year in which it was paid and not in the year in which it accrued. If, therefore, in view of all the facts, the Company's 1916 return was made on a cash basis, it is clear that the appellant's case must fail.

In the foregoing discussion it has been assumed for the sake of argument that in view of the method in which the Burton-Richards Company kept its accounts in the years 1916 and 1917, and the manner in which its returns for those years were made, it may be said that such returns were made under the provisions of Section 13(d), and not under the provisions of Sections 10 and 12(a). The fact is, however, that, as the Findings of Fact show, the returns of the Burton-Richards Company for the years 1916 and 1917 were made in all particulars on the statutory cash basis, a basis which was specifically authorized and sanctioned by Congress in Sections 10 and 12(a) of the 1916 Act.

In making its return for 1916 the Company included as gross income, as it was required to do under Articles 91 and 92 of Regulations 33 (Revised), all items of sales in the form

of accounts receivable, whether or not in fact received. It claimed as deductions:

- (1) All items of general expense in the form of accounts payable, whether or not paid in cash,
- (2) A certain amount for depreciation charged off,
- (3) Interest paid, and
- (4) Taxes, domestic, paid.

Admittedly this return was not made on a literal cash basis. But it was made in all respects on what may be termed the statutory cash basis, a basis which, as pointed out heretofore, had become fully established and recognized as the primary basis upon which returns were made, both under the Excise Tax Act of 1909 and the Income Tax Acts of 1913 and 1916.

The fact that the Company took up as gross income and claimed as deduction for business expenses items in the form of accounts receivable and accounts payable does not warrant the conclusion that the return was not made on the statutory cash basis, when interest and taxes were taken in the return only when paid. This method of computing gross income and general expenses had been recognized and required under the Acts of 1909 and 1913, Acts under which returns admittedly could be made only upon the statutory cash basis. The same method of making return was recognized and required under the Commissioner's regulations issued upon the passage of the 1916 Act, and it was not until sometime in 1921 that the Commissioner first took the position that a return made on the basis employed was not a statutory cash return. On the other hand, if the return was made under Section 13(d) it was admittedly incorrect, as evidenced by the action of the Commissioner in refusing to accept it. Under these circumstances it would seem obvious that the return as made must be taken to have been made under Section 10 and 12(a). That being the case,

it follows, as is indeed admitted by the appellant on pages 4 and 5 of its brief, that the Company's 1916 munitions tax was deductible only in 1917, the year in which it was paid.

The Evidence of Election to Use Section 13(d).

Furthermore, the right to make return under Section 13(d) was optional with the taxpayer, a fact which indeed is frankly admitted by the appellant on page 26 of its brief. But the optional alternative accorded by Section 13(d) needs no admission to establish the fact. The phraseology employed in this Section is:

"A corporation * * * *may*, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, * * * " (Italics ours.)

Recognizing the permissive and optional nature of this Section, the Secretary of the Treasury in T. D. 2433, approved January 8, 1917, which is set forth in full on page 51 of the appellant's brief as part of Appendix A, specifically provided:

"Under this provision [namely Section 13(d)] it will be *permissible* for corporations which accrue on their books", etc. (Italics ours.)

And again:

"In cases wherein * * * corporations set up and maintain reserves to meet liabilities, * * * it will be *permissible* for the corporations to deduct", etc. (Italics ours.)

Section 13(d) being optional with the taxpayer, obviously it is necessary that if a return is made thereunder, there must be some evidence of an election so to make the return. The evidence of record conclusively negatives such an election. All the items appearing on the Company's return for 1916, namely, items of gross income, business expenses, deprecia-

tion, interest and taxes, are correctly taken on the statutory cash basis authorized in Sections 10 and 12(a).

Upon the appellant's theory, the only difference between returns under Section 13(d) and returns under Sections 10 and 12(a), would, in the case of this appellee and other manufacturers, lie in the treatment of interest and taxes. Admittedly, no question arises in this case in regard to interest. Under these circumstances the fact that the treatment of taxes is incorrect on the appellant's theory of a proper return under Section 13(d) and is correct according to the Commissioner's regulations relating to return under Section 10 and 12(a), at least negatives any election to make a return under Sections 13(d), if it does not affirmatively indicate an election to make the return under Sections 10 and 12(a).

The appellant lays so much stress on the fact that in the taxpayer's return deductions were taken for Expenses General (under which the cost of goods sold were properly included) which had not been actually paid in cash, that we deem it proper to reiterate that this was required or permitted by the Commissioner in the returns of every manufacturer made under Sections 10 and 12(a) of the Act of 1916 or under the corresponding provisions of the Act of 1909 and 1913, from the enactment of the first Corporation Excise Tax Law in 1909. Such treatment of expense at the time it was adopted by the taxpayer undeniably constituted nothing more than compliance with the regulations relating to returns under Sections 10 and 12(a), and should be so regarded. The appellant is wholly unwarranted in attempting to spell out an election from this treatment because it has years after the event changed its views as to the way the items should have been treated if the taxpayers had wished to avoid being drawn into the net of Section 13(d).

For Section 13(d) as the appellant seeks to interpret it is in reality a trap instead of an option, since the only result of recourse to it would be that the taxpayer would be deprived of the benefit of a deduction for taxes in one year on the ground that they were not paid, and in the subsequent

year on the ground that they had accrued in the earlier year. The appellant at page 43 of its brief admits this fact as follows:

"It is suggested that the shifting of the basis for income tax returns from the cash receipts and disbursements basis to an accrual basis might operate in the process to prevent the taxpayer from receiving credit as a deduction for some items which were not deductible while the cash system was in effect because not actually paid, and could not be deducted when the accrual system was adopted because they had previously accrued. Such situations do arise where a shifting basis for income taxes is adopted, * * *"

It attempts, however, to minimize the force of this contention by saying that "a corollary of the proposition is that some items of income which have been earned never have to be reported". This statement of the situation is wholly inaccurate, at least as regards all those engaged in manufacturing, mining or merchandizing, for, as we have already pointed out, all such taxpayers were required even on the so-called cash basis to report income from sales which had "accrued", so that the change from the so-called cash basis to the so-called accrual basis would not affect their gross income in any way. In all such cases, change to the accrual basis on the appellant's theory modifies only the treatment of interest and taxes, and results in denying deductions to the taxpayers under these two heads in precisely the manner indicated in the appellant's brief.

Reviewing its contentions on this point, the appellees assert that under the provisions of the 1916 Act the Burton-Richards Company was entitled to make its returns for 1916 and 1917 on the statutory cash basis under Sections 10 and 12(a), that the return as made was a correct return under those Sections, and that under these circumstances the Company cannot be held to have made its return under Section 13(d).

The Alleged Inconsistency in Appellees' Position.

The Government's whole case rests substantially on the suggestion of inconsistency. It points to diversity of treatment of taxes and expenses by the taxpayer and insists that the treatment of taxes be made to conform to the treatment of expenses. But diversity is not necessarily inconsistency, and the diversity in the nature of taxes and expenses is itself a sufficient justification of the diversity of treatment of the two items in the taxpayer's return, just as it was a sufficient justification of the diversity of treatment of expenses and taxes in all the Regulations made by the Commissioner from 1909 up to and including the Regulations under which the returns herein involved were made.

In undertaking to correct the alleged inconsistency, the Government is led into inconsistencies far greater than any of which it complains.

In 1917 the Commissioner said that the taxpayer *could not* take the tax here involved as a deduction in 1916, but could take it in 1917. In 1922 on the basis of L. O. 1059 he said the taxpayer *must* make its returns so as to take this deduction in 1916 in the face of the plain language of the statute saying that the tax could be taken in the year in which paid. The Government's position now is that the taxpayer *had an option* but must be deemed to have exercised the option by keeping its books and making its returns in accordance with the methods prescribed by the Commissioner before any basis other than that on which the taxpayer's return was made was ever sanctioned by Congress. The Government then insists that the taxpayer shall make its return on "the accrual" basis, which it explains as meaning that the taxpayer should take up in its return those items that it had "accrued" or set up on its books. The only change which it claims that this necessitates is in the item taxes. But the Commissioner does not allow taxes as set up or accrued on the books though that computation was undeniably completely consistent with the rest of the Company's accounting.

Instead he says the taxpayer must deduct taxes accrued, using accrue in an entirely different sense, that of taxes legally accrued. Finally, in order to complete the chain that is necessary to success in this case, the Government now asks the Court to revise its decision in the *Woodward* case regarding the legal meaning of the phrase "taxes accrued". All this merely to cure the so-called inconsistency with which the Commissioner found no fault until at least four or five years after the return was filed, and which turns out after all not to be an inconsistency but merely a diversity in treatment of items of a diverse nature.

Conclusion.

In conclusion, we respectfully submit that no error was committed by the Court below and that the judgment entered should be affirmed.

Respectfully submitted,

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APPENDIX A.

There appears below a comparison of the relative provisions of the Internal Revenue Acts of 1909, 1913 and 1916 regarding the respective methods of arriving at net income. The italics are ours unless otherwise indicated.

1909 ACT

Sec. 38. That every corporation . . . shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation . . . equivalent to one percentum upon the entire net income over and above five thousand dollars received by it from all sources during such year.

SECOND. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation . . . received within the year from all sources—

(first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties . . .

(second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any. . . .

(third) interest actually paid within the year on its bonded or other indebtedness to an amount, etc.

1913 ACT

G. (a) That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation. . . .

(b) Such net income shall be ascertained by deducting from the gross amount of the income of such corporation . . . received within the year from all sources—

(first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties,

(second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any;

(third) the amount of interest accrued and paid within the year on its indebtedness to an amount, etc.

1916 ACT

Sec. 10. That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation . . . a tax of two per centum upon such income; . . .

Sec. 12(a). In the case of a corporation . . . organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year in the maintenance of its business and properties.

(Second). All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade.

Third. The amount of interest paid within the year on its indebtedness to an amount of such indebtedness, etc.

1909 Act

(fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any state or territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein.

1913 Act

(fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof or the District of Columbia.

1916 Act

Fourth. Taxes paid within the year imposed by the authority of the United States, or its Territories, or possessions, or any foreign country, or under the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits.

It should be noted that while the phraseology used in the 1913 Act, paragraph G (a) is somewhat different from that appearing in the 1909 Act, in that the tax is upon the entire net income "arising or accruing" from all sources, the Supreme Court of the United States in *Maryland Casualty Co. v. United States*, 251 U. S. 342, has given it the same meaning, and in the subsequent Act, namely, the 1916 Act, Congress returned to the phraseology of the earlier Act.

Cash basis - See Regulations

(That is not accrual)

APPENDIX B.

Comparison of Regulations 31 and 33 under 1909, 1913 and 1916 Acts, Relating to Gross Income, Inventories, Business Expenses, Taxes and Net Income. The italics are ours unless otherwise indicated.

Regulations 31
Issued Dec. 3, 1909
1909 Act

Regulations 33
Issued Jan. 5, 1914
1913 Act

Regulations 33
Issued Jan. 2, 1918
1916 Act

Article 2.—The following definitions and rules are given for determining the gross income of the various classes of corporations:

3. *Manufacturing companies.*—Gross income received during the year from all sources will consist of the total amount, ascertained through an accounting, that shows the difference between the price received for the goods as sold and the cost of such goods as manufactured. The cost of goods manufactured shall be ascertained by an addition of a charge to the account of the goods manufactured during the year of the sum of the *inventory* at the beginning of the year and a credit to the account of the sum of the inventory at the end of the year. . . .

In the determination of the cost of goods manufactured and sold as above such cost shall comprehend all charges for maintenance and operation of manufacturing plant, but shall not embrace allowances for depreciation of property nor for losses sustained which are to be taken account of in ascertaining the net income subject to tax under the proper heading in the authorized deductions.

Article 104.—Gross income of manufacturing companies shall consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the *inventories* of finished and unfinished products, raw material, etc., at the beginning and end of the year. To this amount should be added the income, gains, or profits from all other sources as shown by the books of account.

Article 91.—*Manufacturing corporations*—Gross income for the purpose of returns of manufacturing companies shall consist of the total sales plus the *inventory* at the end of the year less the sum of the cost of goods or materials purchased during the year and the inventory at the beginning of the year. * * *

Article 92.—All sales made during the year, whether compensated for by accounts receivable, bills receivable, cash or other property at a determined cash value, must be included in gross income of the year in which the sales were made.

see page 17
of Gov - for see
13 (a) - 13 (a)

Regulations 31
Issued Dec. 3, 1909
1909 Act

Article 5. Inventories—It will be noted that an inventory or its equivalent of materials, supplies, and merchandise on hand for use or sale at the close of each calendar year is essential in the case of certain corporations in order to determine the gross income, and in case of other corporations to determine their expenses of operation. Where such inventory or its equivalent was not taken at the close of the year 1908, a supplemental statement showing such inventory approximately must be submitted with the return on the regular form. * * *

Article 4. Deductions—The specified deductions actually paid within the year, set forth in the statute and as described in article 3 preceding, shall include all proper items of expenses and charges under the respective heads as designated. * * *

It is immaterial whether the deductions are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books as to constitute a liability against the assets of the corporation, joint-stock company, association, or insurance company making the return.

Regulations 33
Issued Jan. 5, 1914
1913 Act

Article 161. In order that certain classes of corporations may arrive at their correct income, it is necessary that an inventory, or its equivalent, of materials, supplies, and merchandise on hand for use or sale at the close of each calendar year shall be made in order to determine the gross income or to determine the expense of operation.

A physical inventory is at all times preferred, but where a physical inventory is impossible and an equivalent inventory is equally accurate, the latter will be acceptable.

Article 158. It is immaterial whether the deductions *except for taxes* and losses are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation making the return. *Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of the corporation.* Deductions for losses should be confined to losses actually sustained and charged off during the year and not compensated by insurance or otherwise. Except as the same may be modified by the provisions of the act, limiting certain deductions and authorizing others, the net income as returned for the purpose of the tax should be the same as that shown by the books or the annual balance sheet.

Regulations 33
Issued Jan. 2, 1918
1916 Act

Article 120 * * * In all cases where inventories are taken (and they must be taken where the business consists of buying and selling commercial commodities) for the purpose of ascertaining the gain or loss resulting from the business of the year * * *.

Article 126. "Paid" or "actually paid," within the meaning of this title, does not necessarily contemplate that there shall be an actual disbursement in cash or its equivalent. *If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly deductible even though not actually disbursed in cash,* provided it is so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis.

non-accrual

new

Regulations 31
Issued Dec. 3, 1909
1909 Act

Regulations 33
Issued Jan. 5, 1914
1913 Act

Regulations 33
Issued Jan. 2, 1918
1916 Act

T. D. 1742—Par. 77—Reserves for taxes cannot be allowed, as the law specifically provides that only such sums as *are paid* within the year for taxes can be deducted.

*NOTE:—The words "are paid" are italicized in the official text.

Article 152. All sums *paid within the year* for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country, are deductible from gross income.

Article 156. *Reserves for taxes cannot be allowed*, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted.

Article 191. Taxes deductible. —Taxes imposed against a corporation by authority of the United States (except income and excess-profits taxes) its territories or any foreign country, or by authority of any State, county, school district, municipality, or other taxing subdivision of a State (not including those assessed against local benefits) *and paid within the year* for which the return is made, are deductible from the gross income of a domestic corporation.

NOTE:—See also the instructions relating to taxes deductible appearing on the back of Form 1031, returns by corporations, authorized for use for the 1916 return, which instructions are as follows:

"Taxes deductible under these items are such taxes as are imposed by the United States, by any State or Territory, or by any political subdivision thereof, or by the Government of any foreign country, and are actually paid or accrued on the books of the corporation, not in excess of the amount due and payable within the year for which the return is made, . . ."

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Regulations 31
Issued Dec. 3, 1909
1909 Act

Article 3. Net income * * *
The net income, therefore, is the remainder of the gross income after making the specified deductions.

Regulations 33
Issued Jan. 5, 1914
1913 Act

Article 3. The NET INCOME shall consist of the total gains, profits, and income derived from all sources (designated as gross income) less deductions numbered first to sixth, inclusive, specifically enumerated in paragraph B of the Act.

Regulations 33
Issued Jan. 2, 1918
1916 Act

NET INCOME

Article 196. Act of September 8, 1916, as amended.—The net income upon which the tax imposed by section 10 of Title 1 of the Act of September 8, 1916, as amended, is levied is that portion of the gross income received from all sources (except from interest on the obligations of the United States or its possessions, or on the obligations of a State or political subdivision thereof) which remains after all authorized deductions have been taken into account.